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INFO RUEHBJ/AMEMBASSY BEIJING 3147
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RUCPDO/DEPT OF COMMERCE WASHINGTON DC
RHMFISS/DEPT OF ENERGY WASHINGTON DC
RUEHC/DEPT OF LABOR WASHINGTON DC
RULSDMK/DEPT OF TRANSPORTATION WASHINGTON DC
RUEATRS/DEPT OF TREASURY WASHINGTON DC
RUEHGZ/AMCONSUL GUANGZHOU 0724
RUEHHK/AMCONSUL HONG KONG 2431
RUEHLO/AMEMBASSY LONDON 8778
RUEHML/AMEMBASSY MANILA 0123
RHEHAAA/NSC WASHINGTON DC
RUEHUL/AMEMBASSY SEOUL 0595
RUEHGH/AMCONSUL SHANGHAI 9019
RUEHSH/AMCONSUL SHENYANG 2258
RUEHIN/AIT TAIPEI 2057
RUEHKO/AMEMBASSY TOKYO 0806

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DEPT FOR EAP/CM
NSC FOR LOI, SHRIER
STATE PASS USTR FOR STRATFORD/WINTER/MCCARTIN/KATZ/MAIN
USDOC FOR ITA DAS KASOFF, MELCHER, SZYMANSKI, MAC/OCEA
TREASURY FOR OASIA/INA -- DOHNER/HAARSAGER/WINSHIP
TREASURY FOR IMFP -- SOBEL/CUSHMAN
STATE PASS CEA FOR BLOCK
STATE PASS CFTC FOR OIA/GORLICK
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E.O. 12958: N/A

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SUBJECT: JIANGSU PURSUES INVESTMENT-FUELED GROWTH DESPITE CENTRAL CONCERNS ABOUT FUTURE RISKS

¶1. (SBU) Summary: With little regard for Central Government concerns about investment bubbles or overcapacity, Jiangsu -- East China's largest province -- is tapping a locally funded government stimulus program and lending to large firms to rack up impressive growth figures even as net exports remain a drag. This lopsided dependence on investment means that only limited progress has been made on sparking domestic consumption as a major economic driver. Looking forward, the current investment binge will be difficult to wind down before a rise in industrial overcapacity and inefficient infrastructure presents new problems, including more nonperforming loans. End Summary.

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Background
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¶2. (SBU) EconOff traveled to Nanjing, the capital of Jiangsu Province, October 22-23, 2009, to meet with local academics, government think-tank researchers, and businesspersons to gauge local economic conditions. As described below, a picture emerged of province-wide economic growth, but with serious concerns about the long-term sustainability of this growth. Note that several contacts raised questions about the accuracy and consistency of Jiangsu's economic data, which are covered in septel.

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Exports are Slowing, Leaving Investment . . .
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¶3. (SBU) Overall, the province officially grew 11.7 percent in January-September, according to statistics released by the Jiangsu Bureau of Statistics on October 23, a full 5 percentage

points higher than the 7.7 percent national growth recorded in the same period. With exports still a net drag on economic growth -- down 22.7 percent in the first three quarters of 2009 compared with the same period last year -- Jiangsu is relying on investment and consumption. Hu Guoliang, deputy director of the Economic Research Institute of the Jiangsu Academy of Social Sciences (JSASS), said that in the first half of the year, investment accounted for 54.5 percent of GDP growth, consumption 58.9 percent, and net exports -13.4 percent. (Note: In China's GDP accounting, consumption includes government spending. End note.)

¶4. (SBU) Wu Min, chief economist of the Nanjing Municipal Development and Reform Commission (Nanjing DRC) said the Nanjing municipal government had set aside RMB60 billion for public investment stimulus spending, which was intended to draw in another RMB250 billion in matching funding from enterprises and banks. (Note: Approximately US\$8.8 billion and US\$36.6 billion, respectively. End note.) She noted that Nanjing would not be able to fund large projects such as its subway system through tax revenues alone, and therefore has four publicly sponsored investment platforms through which it can borrow money, including two major ones called the Nanjing Communications Construction Investment Control Stock (Group) Co., Ltd. and the Nanjing Urban Construction Investment Holding (Group) Co., Ltd. Wu said investment by government and industry was particularly instrumental to the faster-than-provincial-average growth in northern Jiangsu.

¶5. (SBU) In addition to government-directed investment, some interlocutors pointed to market factors driving investment into Jiangsu's manufacturing base. Prof. Zhao Shudong, head of

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Nanjing University's International Economics Department, noted Jiangsu continues to attract the greatest foreign direct investment (FDI) of China's provinces. (Note: In 2008, Jiangsu took in over US\$25 billion in FDI, accounting for over 23 percent of China's total. End note.) Several contacts pointed to companies consolidating their production in Jiangsu, to take advantage of lower costs. JSASS researcher Hu pointed out Jiangsu is similar to Shanghai in terms of public order and labor quality, but that costs can be 60 percent lower in Jiangsu, due to lower rents and lower labor costs -- especially lower salaries for managers. In fact, many of the contacts saw this as a natural process of manufacturing capacity leaving Shanghai and flowing into Jiangsu and elsewhere in the Yangtze River Delta. (Note: See septel for more on how this process might explain, in part, Jiangsu's higher GDP growth. End note.)

¶6. (SBU) Jiangsu government officials and firm managers are especially focused on investing in new energy technologies in order to maintain Jiangsu's lead in this sector. This is an example of Jiangsu's strong science and technology research base, said Zhao, which has pushed Jiangsu up the value-added production ladder and allowed it to better survive the crisis than Guangdong, where factories are more concentrated on low-value-added processing. As an example, he pointed out government and corporate leaders have come together to create a large-scale wind farm in Nantong that will eventually produce more power than the Three Gorges Dam. Sheng Li, the deputy general manager of Everbright Bank's Nanjing Branch, which has operations through Jiangsu, said she sees strong competitiveness in Jiangsu's solar and wind power production, as well as electronics such as flat-screen display panels. JSASS's Hu said Jiangsu is emphasizing development of ocean shipping, biopharmaceuticals, logistics, agricultural biotechnology, and clean energy.

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. . . and Consumption to Drive the Economy
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¶7. (SBU) Jiangsu's consumption contribution of 58.9 percent to provincial GDP growth in the first half is one of the highest levels reached in the past 20 years. While part of this is

government consumption, the Nanjing interlocutors also pointed to rising consumption by private households -- in particular, purchases of real estate. Chen Xinghan, chair of the board of Chixia Development and president of the Jiangsu Real Estate Association, said she was surprised by the demand for residential housing spurred by the Central Government's incentives introduced at the end of 2008, which included greater leniency for second home purchases, higher mortgage underwriting by banks, and adjustment of land prices by local governments. Chen said more than 50 percent of domestic consumption in Jiangsu is related to real estate, including 35 percent for new housing and 10 percent for existing housing. Altogether, she said, 56 industries depend on real estate for growth. (Note: The Nanjing Municipal Statistical Bureau reported sales volume for residential real estate was up 111.8 percent in the first three quarters. End note.)

18. (SBU) Some other sectors are also showing high growth in retail sales, say the contacts. Nanjing DRC's Wu pointed out sales of private vehicles in Nanjing was up over 30 percent in the first three quarters. Sang Naiquan, an economist at Nanjing University of Finance and Economics (NUFE), said Jiangsu's export-dependent electronics industries were taking advantage of

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the Central Government's tax breaks under the "Household Electronics to the Countryside" program to sell into rural markets. (Note: Household disposable income grew 10.7 percent in urban areas and 10.1 percent for rural ones in the first three quarters, according to Jiangsu official data. End note.)

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Concern That State Interference is Growing . . .
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19. (SBU) Despite the rosy picture painted on GDP growth, interlocutors expressed some concerns the state sector was becoming too dominant in Jiangsu's growth pattern. Nanjing University's Zhao said state-owned enterprises are not as efficient at using investments. He cited U.S. economist Paul Krugman, saying that sometimes this money is used to buy worthless garbage. This was part of the trend of "government [involvement in the economy] increasing, private [economic activity] decreasing" (guojin, mintui), said Zhao. At the same time, Zhao warned against over generalizing, noting, for instance, that the trend of SOEs taking over private firms through mergers and acquisitions is only temporary.

110. (SBU) Everbright's Sheng agreed large companies, including many SOEs, are gaining ground, but did not see the trend subsiding. China's industry is undergoing consolidation, she said, and in 2-3 years, the province's large firms will have an even greater market share, giving them market power. She said it remains hard to channel funds to small- and medium-size enterprises (SMEs), despite Central Government policies, since SME loans have much higher verification and monitoring costs. SMEs have dropped as a share of Everbright Nanjing's loan book, because SME lending has held steady while lending to large firms has grown sharply.

111. (SBU) However, contacts also pointed out that SOEs form part of Jiangsu's competitiveness. Everbright's Sheng said Jiangsu has a greater ability to resist economic risk, implying SOEs can draw on government support in hard times. In addition, the government is able to implement economic policy more effectively through SOEs through better control over SOE investment, she said. Nanjing University economics professor Shi Xiancheng noted the academic literature is mixed on whether SOEs can be efficient producers, while colleague Chen Baomin said Jiangsu's greater government involvement in the economy leads to better public goods than in Zhejiang.

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. . . Which Could Lead to Overinvestment . . .
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¶12. (SBU) With market signals for investment distorted by the large economic stimulus flows, investment in Jiangsu is less likely to scale back in the face of emerging signs of overcapacity in some industries, agreed all the Nanjing interlocutors. Many raised the real estate industry in this context. NUFE's Sang said, for instance, the Central Government wants to control the real estate market, but local governments are eager for some inflation in this market, as it supports their income from land sales. Local governments are following this course even though it reduces the buying power of ordinary households and thereby increases social tensions, said Sang. Chixia's Chen said that the rapid increases in real estate prices are propelled in part by the government's loose monetary policy, which has channeled funding to businesses that have

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nowhere to invest the money but in real estate and the stock market. Chen also warned that local governments could become too reliant on the real estate sector, although she was more sanguine that housing purchase incentives would be allowed to expire at the end of 2009, helping dampen demand in 2010.

¶13. (SBU) The Nanjing contacts said that while overinvestment could lead to deflation in final goods prices, it could also lead to inflation in key inputs and upstream commodities. NUFE's Sang said the government must chose the proper balance between stimulus-led economic growth and managing inflation expectations. He warned that the highest inflation ordinary households can support is 20 percent -- which is the high point reached during the period of economic reforms. Inflation causes instability because it essentially takes from poor savers and gives to rich owners of capital. Nanjing DRC's Wu Min also put inflation at the top of her list of concerns in the coming year.

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. . . And Future Financial System Strains
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¶14. (SBU) Some contacts offered warnings about problems with record bank lending in China this year, which has been directed by the government to support its stimulus program. (Note: As of September, bank lending in China had risen 149 percent over the same period the previous year. End note.) Nanjing University's Zhao said bluntly, "China has paid a large price for the financial crisis, and not all the impacts have yet emerged." He worried that the financial cost could become more pronounced as China enters into a period of rapid population aging and loses some economic growth momentum.

¶15. (SBU) NUFE's Sang said the short-term risk with the lending surge is that liquidity flowed into speculation, but that the real problem is medium- and long-term loans. While the National Development and Reform Commission (NDRC) has dispatched people to monitor the projects, said Sang, local government management of projects will play a key role in generating an appropriate return on investment. Everbright's Sheng said her bank has already exceeded the China Banking Regulatory Commission's guideline of setting aside 150 percent of nonperforming loans as a provision for possible future losses -- Everbright Nanjing is currently provisioning at 190 percent.

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But Jiangsu Still Hoping to "Win" the Investment Race
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¶16. (SBU) Despite these potential problems, one of the most frequently heard comments was that Jiangsu should continue aggressively to develop its industries -- even those among industries declared by the NDRC to have overcapacity -- because increased market share would position it better for the coming industry shakeouts. (Note: On October 15, the NDRC named steel, cement, plate glass, coal-chemicals, polycrystalline silicon, and windpower equipment as the focus of its crackdown on overcapacity industries. It also warned of obvious overcapacity in aluminum, shipbuilding, and soybean pressing industries. End note.)

¶17. (SBU) Everbright's Sheng said that Jiangsu wind and solar power equipment companies were planning to increase their capacity to widen their current low-cost advantage; already, China's top eight solar panel companies are based in Jiangsu,

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she noted. JSASS's Hu said that the current overcapacity in wind and solar power results from a demand shortfall, since final goods prices remain high. Increased production scale will bring down prices, and stimulate demand, he said. Nanjing DRC's Wu said that wind and solar power equipment manufacturing capacity on which investment has already started should be completed. She pointed to a possible motivation for local governments to continue investing in the sector, saying, "It is impossible to get rid of projects that are already in place."

¶18. (SBU) Underlying many of these statements was a sense that Jiangsu -- and in particular its capital, Nanjing -- should not play second fiddle in the region, and should be left alone by the Central Government to develop the local economy. JSASS's Hu said that Shanghai wants to be the "dragonhead" in the Yangtze River Delta, with Jiangsu and Zhejiang as the wings. However, Jiangsu's economy is bigger than Shanghai's, so why should it take the supporting role? Hu and NUFEE's Sang noted that Nanjing Municipality serves as a natural center for an economic region that stretches into Anhui.

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Comment
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¶19. (SBU) Despite the Central Government this fall launching efforts to reel back local government investment, the lack of incentive in Jiangsu to comply is obvious. All signs point to officials across the province vigorously protecting local growth sources, including both real estate as well as industries with officially designated overcapacity.

¶20. (SBU) At the same time, aside from the possible bubble reinflating in the residential real estate sector, there is little evidence that Jiangsu officials are encouraging private consumption. In fact, disposable household income growth continues to lag provincial GDP growth, with the result that household consumption -- if measured separately from government consumption, with which it is lumped together in the Chinese GDP accounting system -- is most likely falling as an overall share.
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